

Investment Strategy

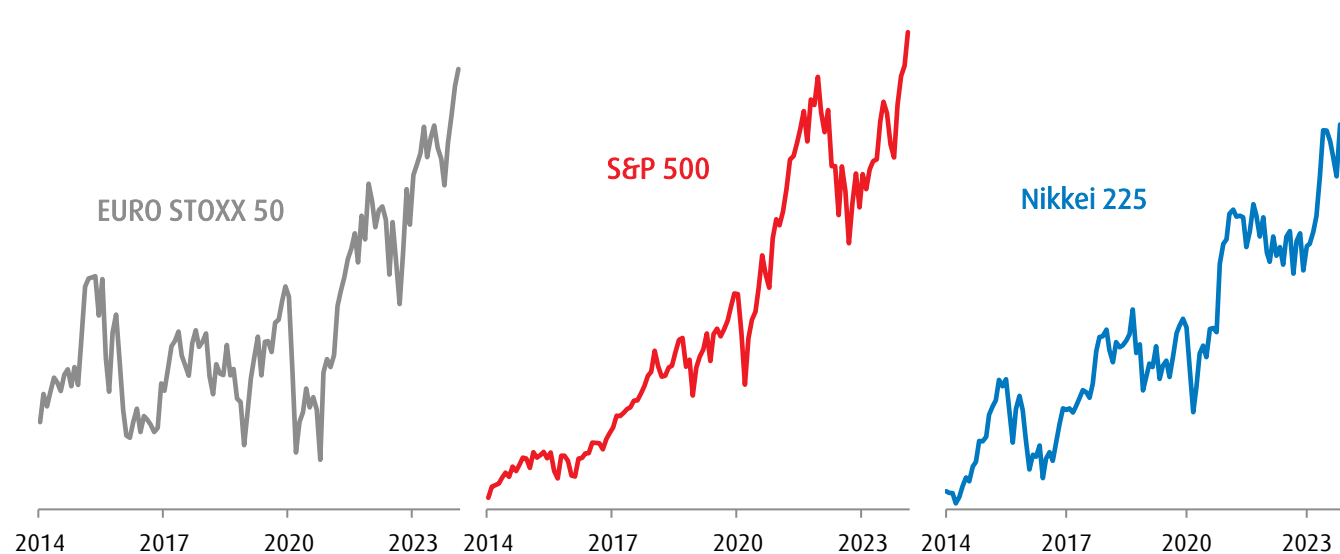
BMO Nesbitt Burns | March 2024

Stéphane Rochon, CFA Equity Strategist
Richard Belley, CFA Fixed Income Strategist
Russ Visch, CMT Technical Analyst
Eric Yoo, Associate
Ernad Sijercic, Associate

Productivity acceleration – the holy grail for investors

Global stock markets have continued to defy various bearish accounts in 2023 and so far in 2024. With the notable exception of China, which is mired in a painful growth slowdown, major stock markets across the world, notably Europe (EURO STOXX 50), North America (Dow and S&P 500), and Japan (Nikkei) have made new all-time highs. Given equity markets are among the best leading economic indicators, this at the very least does not portend a global recession in the next few quarters.

Figure 1: Fresh Highs Across the Board – Not a Recessionary Omen



Source: BMO Private Wealth Portfolio Advisory Team, Factset

History tells us that market strength begets more strength. As noted by our colleague Brent Joyce, “after making a new high (following a bear market), the S&P is usually up 88% of the time over the next 3, 6 and 12 months, since 1960. This also appears to be the path of least resistance this time. In the near term, inflation expectations continue to be very well grounded around 2% which should allow central banks to cut rates around mid-year.” The BMO Economics team continues to think the Bank of Canada will begin trimming in June, ahead of the U.S. Federal Reserve (“Fed”). This has clear positive implications since – as noted by our research partners at NDR – bond yields had **always** fallen going into the first cut. This would clearly be a positive for laggard interest rate-sensitive, defensive, and “value” stocks and the relative performance of the TSX vs. the S&P 500. Furthermore, stocks almost always post good gains during easing cycles. Going back to 1970, the median S&P return during easing cycles has been over 25% annualized. The lone exception was in the 2001 – 2003 period which followed the bursting of the tech bubble.

Figure 2: S&P 500 Total Return (Over Cycle)

Start Date	End Date	Length (Calendar Days)	Start Value	End Value	% Change	GPA %
13 Nov 1970	19 Feb 1971	98.00	83.37	96.74	16.04	74.02
19 Nov 1971	17 Dec 1971	28.00	91.61	100.26	9.44	224.19
09 Dec 1974	22 Nov 1976	714.00	65.60	102.59	56.39	25.68
30 May 1980	28 Jul 1980	59.00	111.24	121.43	9.16	71.98
02 Nov 1981	15 Dec 1982	408.00	124.20	135.24	8.89	7.92
21 Nov 1984	21 Aug 1986	638.00	164.52	249.67	51.76	26.95
06 Jun 1989	04 Sep 1992	1186.00	324.24	417.08	28.63	8.06
07 Jul 1995	31 Jan 1996	209.00	553.99	636.02	14.81	27.27
29 Sep 1998	17 Nov 1998	49.00	1049.02	1139.32	8.61	84.98
03 Jan 2001	25 Jun 2003	903.00	1347.56	975.32	(27.62)	(12.25)
18 Sep 2007	31 Oct 2014	2600.00	1519.78	2018.05	32.79	4.06
31 Jul 2019	15 Mar 2022	958.00	2980.38	4262.45	43.02	14.60
Mean					20.99	46.46
Median					15.42	26.32

Source: S&P Dow Jones Indices

Longer term, the key will be continued productivity growth led by the U.S. (as usual), but we also see Canada benefitting from this in time assuming better policies and incentives to increase capital investments (particularly in Technology). While productivity acceleration gets less attention than other major macro variables (because it moves slowly and with a considerable lag following investments), we believe it is crucial as it increases long-term economic and corporate margin growth potential without creating dangerous inflationary pressures. In the current context, we believe enormous investments in artificial intelligence, cloud computing, autonomous vehicles etc. is bound to have a real-world impact. As an example, The Economist recently stated that artificial intelligence is raising productivity for salespeople and coders by a third at tech startups. This is far from trivial for companies that typically burn cash and are racing to generate positive cash flow.

Figure 3: BMO Nesbitt Burns Investment Strategy Committee's Recommended Asset Allocation (%)

	Income		Balanced		Growth		Aggressive Growth	
	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights	Recommended Asset Mix	Benchmark Weights
Cash	0	5	0	5	0	5	0	5
Fixed Income	70	70	40	45	20	25	0	0
Equity	30	25	60	50	80	70	100	95
Canadian Equity	25	15	35	25	45	35	50	40
U.S. Equity	5	5	20	15	20	20	30	30
EAFE Equity	0	5	0	5	5	10	10	15
Emerging Equity	0	0	5	5	10	5	10	10

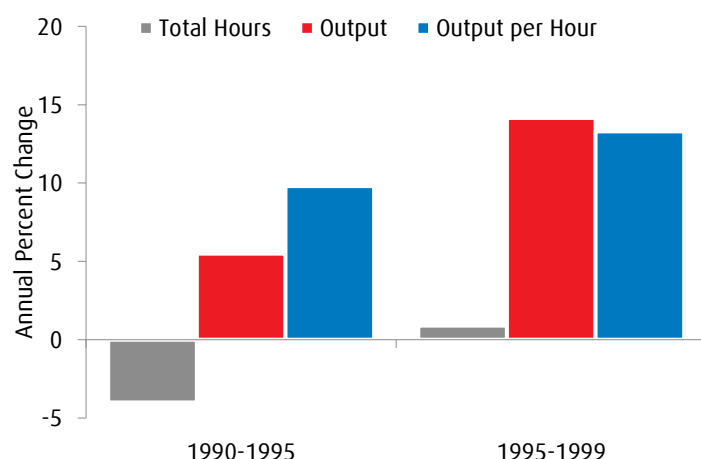
Source: BMO Nesbitt Burns Private Client Strategy Committee

The Nineties Parallel

We have seen some bearish narratives which argue we may fall into a 1970s-type stagflationary cycle which would clearly be very painful for investors (U.S. stocks had negligible returns in that decade). Our own view is that a more likely and constructive scenario for the North American economy and markets is something akin to the 1990s. Back then, investments in computing (PCs and laptops), wireless communications and the internet really took off in the 1980s/early 90s. It took time, however, for employees to truly harness the power of these "new" technology tools but eventually – in the mid-90s – productivity really started accelerating. The Federal Reserve of St. Louis stated that the acceleration of labour productivity growth that began during the mid-1990s was the defining economic event of the decade.

The high-tech Manufacturing sector experienced rapid growth in output per hour throughout the 1990s. The rate of growth accelerated sharply in the second half of the decade.

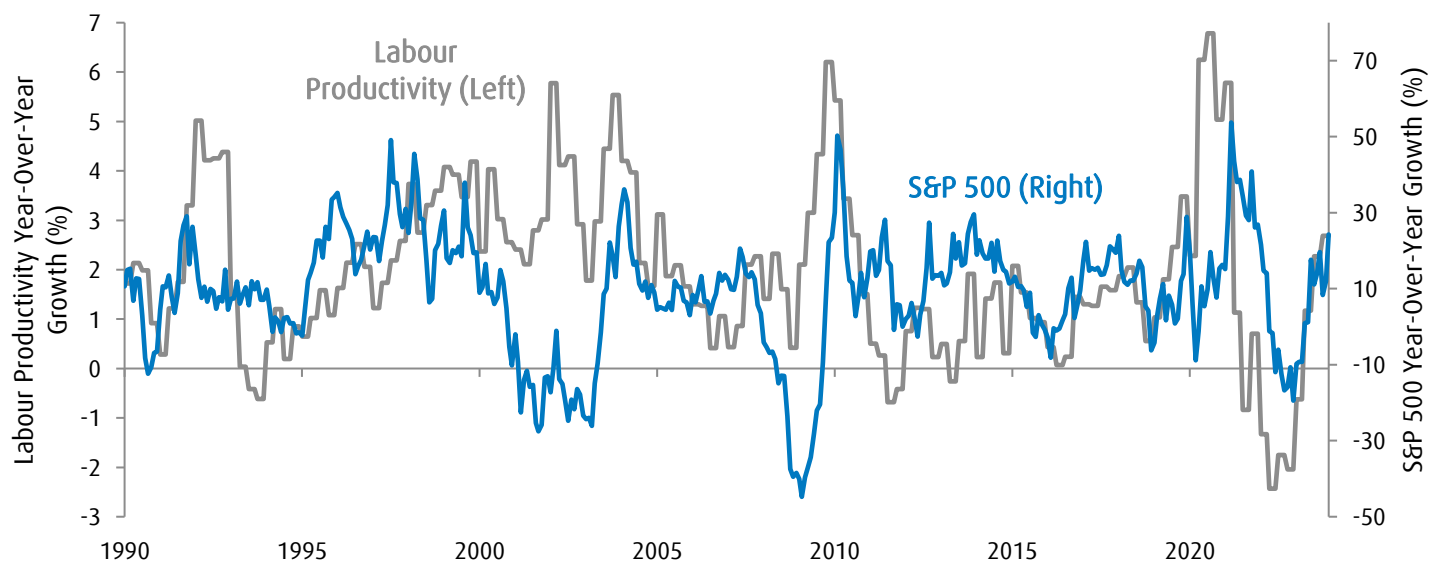
Figure 4: Labour Productivity and Related Measures for High-Tech Industries



Source: BMO Private Wealth Portfolio Advisory Team, U.S. Bureau of Labor Statistics

We believe this was a major contributing factor to the epic bull market we witnessed in that period. It is also worth noting that productivity also accelerated strongly in Canada in the 90s, but we lagged the U.S. This is a plausible scenario for this cycle as well in our view and BMO Chief Economist Doug Porter concurs.

Figure 5: Productivity Acceleration in the 1990s Led to Strong S&P 500 Returns

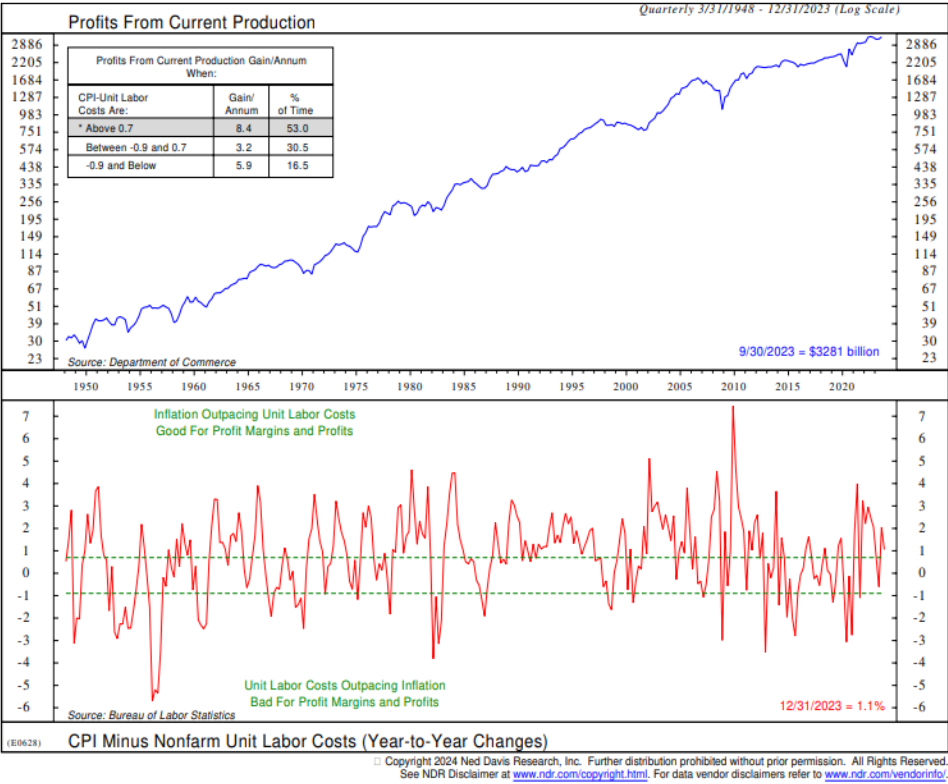


Source: BMO Private Wealth Portfolio Advisory Team, Factset

Current Cycle

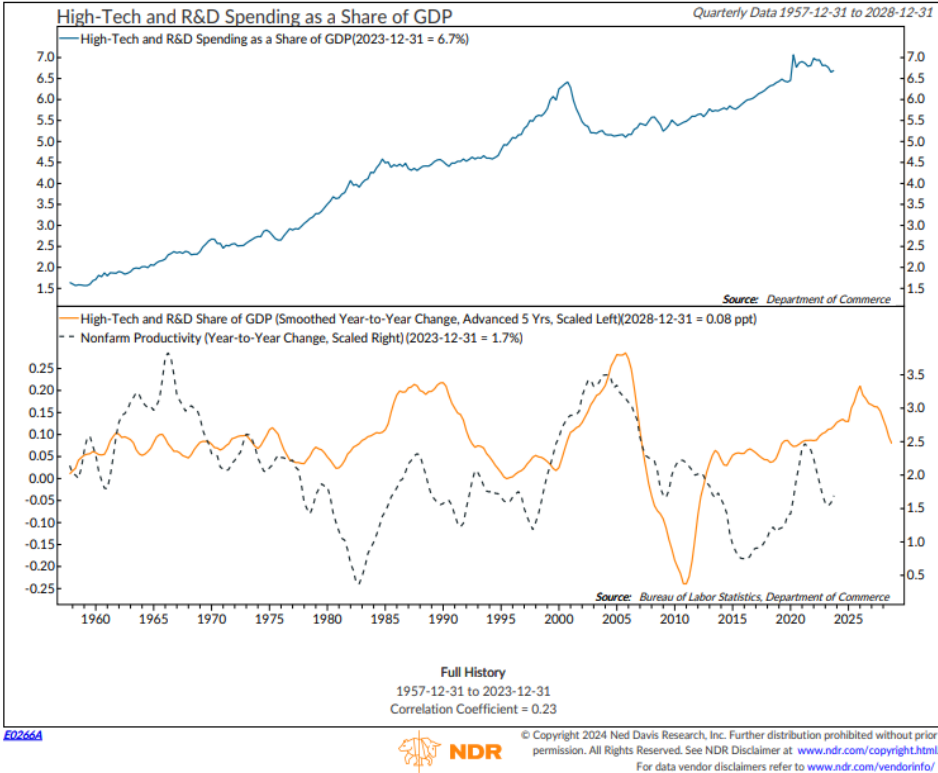
As recently reported, Q4 U.S. productivity came in at 2.7% year-over-year, the fastest pace since Q1 2021. As a result, unit labor costs ("ULC"), or labor costs in excess of productivity, rose only 2.3% year-over-year, near the slowest pace since Q2 2021 (falling inflationary pressure), and well below its five-year average rate. This is a tailwind for margin growth and is historically consistent with above-average stock market gains, as the charts below show. It is supportive of the current upswing in equity prices. The slowdown in ULC growth also implies falling underlying inflation pressures. NDR's productivity proxies show gains across the majority of industries, which argues for sustainability.

Figure 6: CPI-ULC Gap is Positive for Profit Growth



Source: NDR

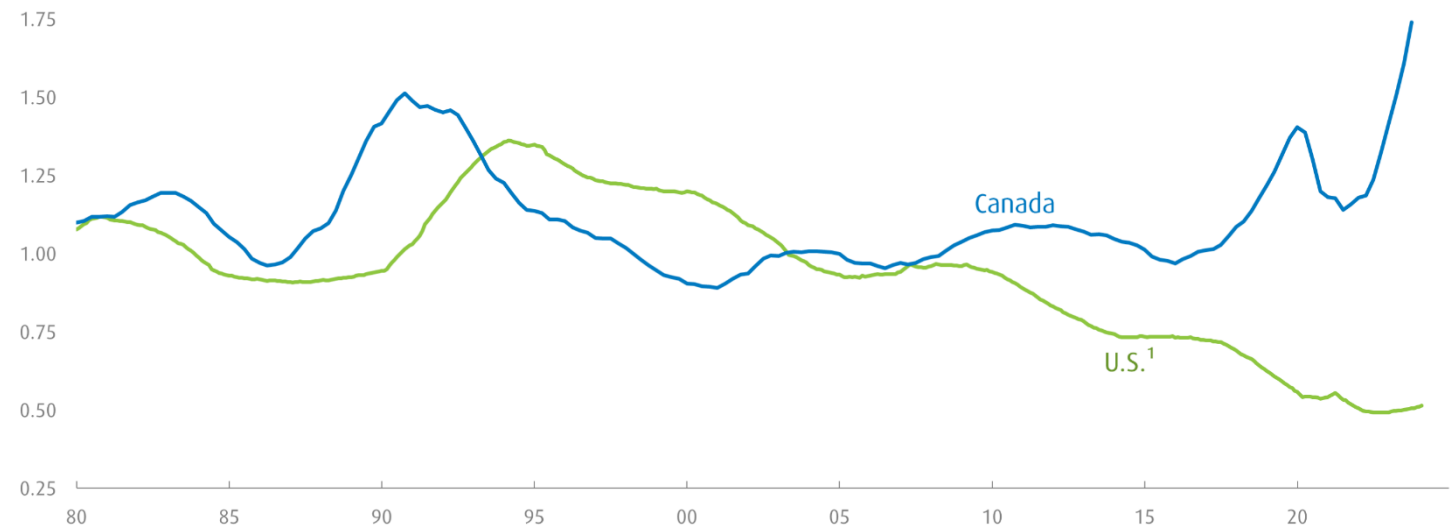
Figure 7: High-Tech and R&D Investment Lead Productivity Growth



Source: NDR

The charts below show the contrast between Canada and the U.S. in terms of population growth (which is helping Canadian absolute economic growth) and business productivity which, as noted above, is now inflecting upward in the U.S.

Figure 8: Population Growth – 4-Year % Change (Annualized Rate)



¹April 2020 Census adjustment averaged over following 12 months

Source: BMO Economics, Haver Analytics

Figure 9: Business Sector Productivity – 5-Year Annual % Change

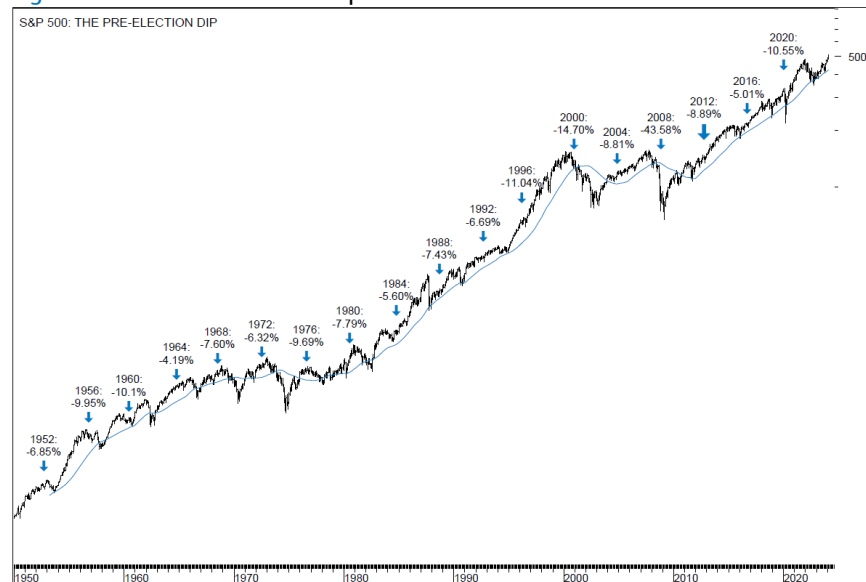


Source: BMO Economics, Haver Analytics

Technical analysis

We never like to use the word "guarantee" in our research, but a pullback in the third quarter of U.S. presidential election years is just about as consistent as you'll ever see in this business.

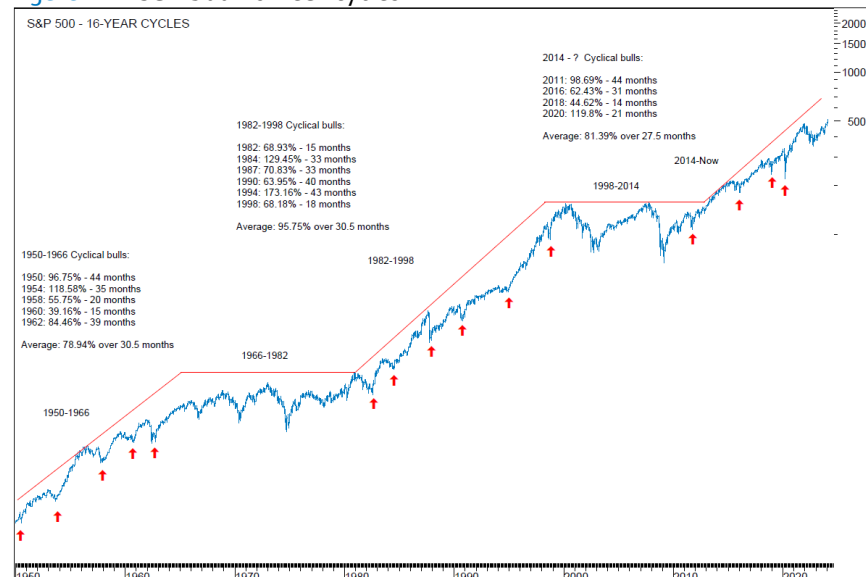
Figure 10: The Pre-Election Dip



Source: BMO Private Wealth Technical Analysis

If you ignore 2008 as an extreme outlier, the average Q3 pullback since 1980 is -8.28% (It's -10.27% if you include 2008.) The good news is that looking at historical averages, we're still only in the "middle innings" with respect to how an average cyclical bull market plays out within bigger secular bull markets. Historically, they tend to last about 30 months with an average gain of 86%. If you apply that to the October 2022 low that would give a 2025 target of 6,493.

Figure 11: S&P 500 16-Year Cycles

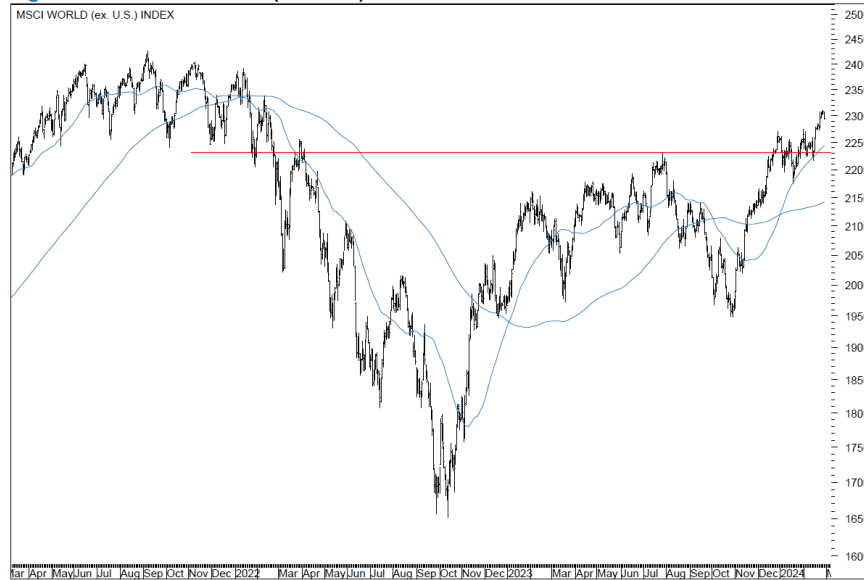


Source: BMO Private Wealth Technical Analysis

Of course, that target seems a bit too ambitious at this point, but history shows a high likelihood of further all-time highs following any mid-year correction and we probably won't run into any significant turbulence until sometime in 2025. In addition, while mega-cap Tech stocks have been getting all the press by carrying the weight for U.S. indexes, global stock markets have actually been doing pretty great themselves. In recent days, Germany, France, Switzerland, South Korea (one of

my key market-based measures of economic activity), Taiwan, India, and Japan have either made 52-week or all-time highs. In fact, Japan just made its first new all-time high since 1989, which is fantastic. As a more general barometer of global stock market activity, the MSCI World Ex. U.S. Index also just made a new 52-week high, so it's not just an AI craze, it's steady improvement in the global economy.

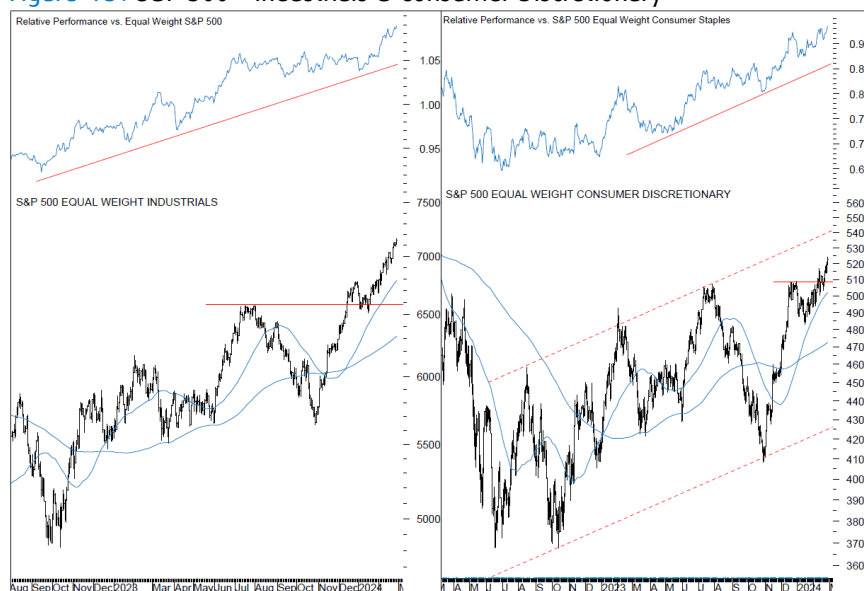
Figure 12: MSCI World (Ex. U.S.)



Source: BMO Private Wealth Technical Analysis

Last but not least, the “canaries in the coal mine” that typically pre-warn of major sell-offs (think 10-15%+) all look great right now as well. This includes key “risk on/risk off” metrics such as the performance of Discretionary vs Staples stocks, Financials vs. Utilities, and the continued outperformance of economically sensitive sectors such as Technology and Industrials which all reflect a healthy economy.

Figure 13: S&P 500 – Industrials & Consumer Discretionary



Source: BMO Private Wealth Technical Analysis

Bond market sentiment gauges also remain sedated: both corporate/treasury credit spreads and credit default swap indexes remain at/near 52-week new lows, which is a good thing, i.e., the bond guys are not worried. Historically, these indicators tend to roll over and go negative anywhere from 6-12 months ahead of real bear markets so until I see a more defensive

shift in those indicators it's still "game on" for equities.

Figure 14: Bond Market Sentiment



Source: BMO Private Wealth Technical Analysis

Figure 15: S&P/TSX Composite Total Returns

S&P/TSX Composite Index Sector Total Returns (%)	MTD	YTD
Industrials	5.69	7.92
Consumer Staples	5.25	7.24
Energy	3.73	5.38
Info. Technology	-1.53	5.11
Health Care	8.51	4.31
Cons. Discretionary	2.19	3.52
S&P/TSX Composite Index	1.82	2.38
Financials	2.30	2.03
Real Estate	-1.25	-1.16
Telecom. Services	-4.69	-1.97
Utilities	-2.35	-3.56
Materials	-2.12	-8.26

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Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

Figure 16: S&P 500 Sector Total Returns

S&P 500 Index Sector Total Returns (%)	MTD	YTD
Telecom. Services	5.70	11.01
Info. Technology	6.31	10.51
Financials	4.16	7.33
S&P 500 Index	5.34	7.11
Health Care	3.22	6.32
Industrials	7.23	6.29
Cons. Discretionary	8.71	4.87
Consumer Staples	2.32	3.89
Energy	3.18	2.79
Materials	6.46	2.30
Utilities	1.12	-1.93
Real Estate	2.45	-2.45

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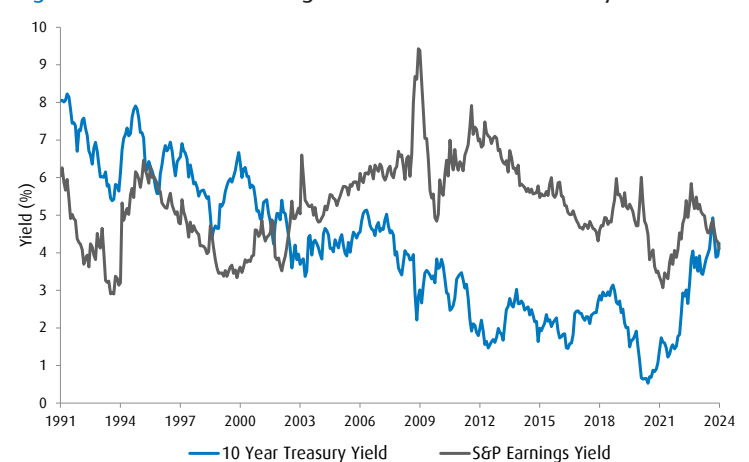
Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

Figure 17: S&P/TSX Composite Earnings Yield vs 10-Yr GoC Yield



Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

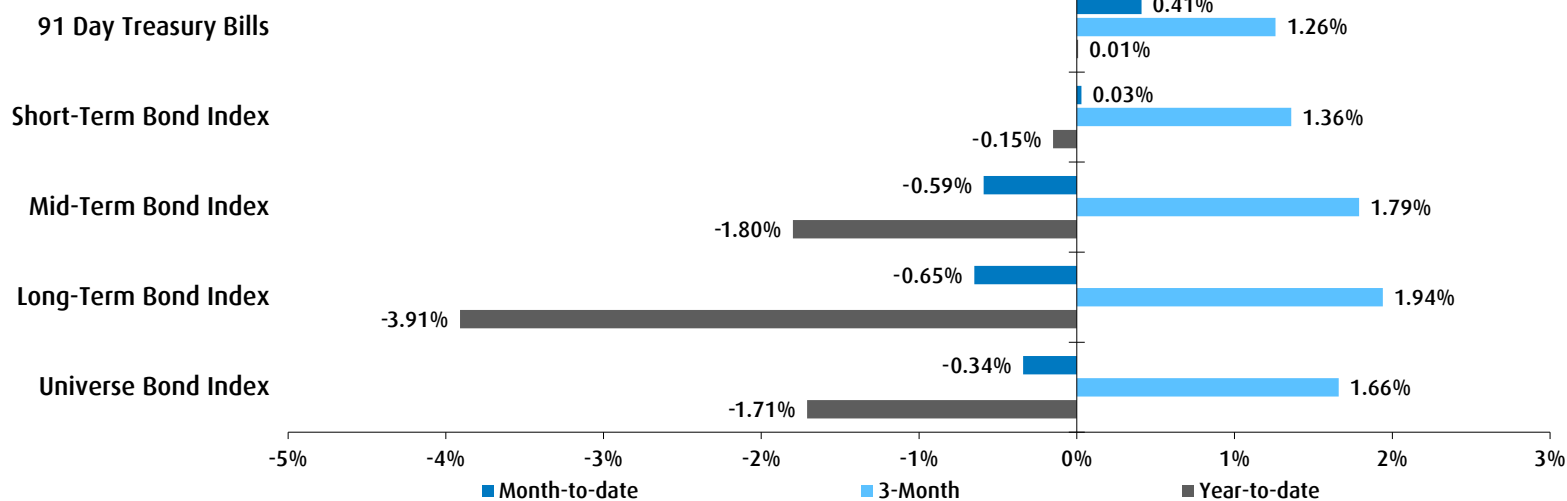
Figure 18: S&P 500 Earnings Yield vs 10-Year Treasury Yield



Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg

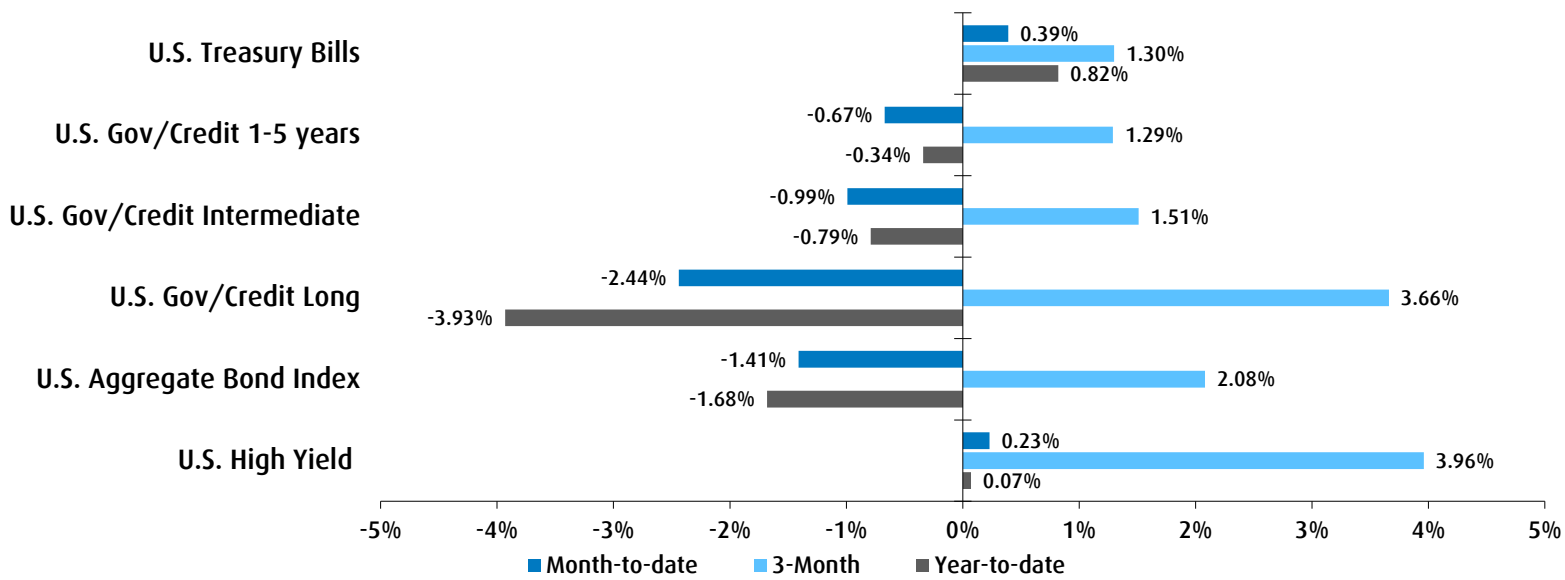
Figure 19: Canada/U.S. Bond Index Total Returns Through February 2024

Canada



Source: BMO Private Wealth Portfolio Advisory Team, FTSE

U.S.



Source: BMO Private Wealth Portfolio Advisory Team, Bloomberg Barclays

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